(24)

IN THE

Supreme Court of the United States

OCTOBER TERM 1941

No. 1196

IN THE MATTER
of
PRUDENCE-BONDS CORPORATION,
Debtor.

IN THE MATTER
of
The Judicial Settlement of the Account of Proceedings of MANUFACTURERS TRUST COMPANY, as Successor Trustee of Prudence-Bonds, Twelfth Series, under Trust Agreement dated February 1, 1928, between Prudence-Bonds Corporation and Chatham Phenix National Bank and Trust Company, as Trustee.

MANUFACTURERS TRUST COMPANY,
Petitioner,
against
CHARLES H. KELBY and CLIFFORD S. KELSEY,
Trustees of the Debtor;
PRUDENCE-BONDS CORPORATION
(New Corporation);
MARY KEANE, et al.;
GEORGE E. EDDY and
PRUDENCE SECURITIES ADVISORY GROUP.

REPLY BRIEF ON BEHALF OF PETITIONER

CHARLES E. HUGHES, JR.,
DAVID BARNETT,
CURTISS ELY FRANK,
Counsel for Petitioner.

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FIRST: As to the standing of respondents to present claims on behalf of all bondholders as a class.

No New York case cited by the respondents holds contrary to the proposition that, where the trustee or other

fiduciary has not misappropriated a part of the *res* for its own benefit, but has at most been guilty of a breach of its fiduciary duties with respect to the *res*, the resulting right of action is individual and personal to the bondholders who had that status at the time of the alleged breach of trust. The cases chiefly stressed (Brief, pp. 17-19) are: *O'Beirne* v. *Bullis*, 80 Hun 570, aff'd sub nom, *O'Brien* v. *Allegheny & Kinzua R. R. Co.*, 151 N. Y. 372, same case, 2 App. Div. 545, aff'd 158 N. Y. 466, rearg. den. 158 N. Y. 719; and *Zebley* v. *Farmers Loan & Trust Co.*, 139 N. Y. 461. While the *O'Beirne* case was brought by a bondholder on behalf of all other bondholders of a mortgage trust indenture, it was not brought against the mortgage trustee (except as a nominal defendant because of its refusal to bring the action). The real defendants were the promoters and sole stockholders of the mortgagor railroad company which received the proceeds of the bond issue on a representation that such defendants owned or controlled certain timberlands which would be brought under the lien of the mortgage pursuant to the contract made by such defendants. The primary relief demanded was for specific performance, but, since it appeared that the defendants did not own most of the land, this was molded to relief for a money judgment. Since the defendants had received the proceeds of the bond issue for expenditure pursuant to the terms of the contract, the cause of action was more analogous to one for misappropriation than for breach of a fiduciary duty such as is here involved.

The *Zebley* case arose upon demurrer to a complaint. The opinion of the court makes no mention of the point that the plaintiff may have been an assignee of the bonds. The only indication of this is in certain quite unspecific language in the complaint as printed in the record on appeal. The defendant's brief in that case shows that it did not include as one of its contentions the argument that plaintiff was precluded from recovery on that ground (Defendant's brief, p. 4). However that may be, the case is also analogous to one of misappropriation. The complaint alleged that the

mortgage trustee had on mortgage foreclosure bought in the mortgaged real estate and conveyed it to a new corporation for some consideration to the plaintiff unknown. The complaint alleged among other things that the defendant "has wrongfully, and in violation of the trust converted to its own use the share of the property or its proceeds to which the plaintiff is entitled under the trust" (139 N. Y. p. 467). That action was not a representative one but rather a suit by an individual bondholder to recover the proportion of the trust assets applicable to his bonds.

All of the cases upon which respondents rely are, with two exceptions, old cases not related to the line of recent authorities which are determinative here. One of the exceptions is *Matter of People (Lawyers Westchester Mortgage & Title Co.)*, 288 N. Y. 40 (Respondent's Brief, p. 24), which is not in point. That was a proceeding involving, not the enforcement of liability against a trustee or fiduciary for breach of fiduciary duties, but against the guarantor of the mortgage certificates upon its contract of guaranty. The court, casting no doubt upon the authority of *Mittlemann* v. *President, etc. of Manhattan Company,* 248 App. Div. 79, aff'd. 272 N. Y. 632, and *Weil* v. *President and Directors of Manhattan Company,* 275 N. Y. 238, held them inapplicable upon that ground. It has never been contended in the Prudence proceedings that causes of actions upon the Prudence Company's contracts of guaranty did not pass to the assignee of the bonds. The other of the two exceptions, *Matter of 22-52 44th Street, Long Island City,* 176 Misc. 249 (Brief, p. 26), also involved the enforcement of rights upon the contract of guaranty and was distinguished upon that ground in *Emmerich* v. *Central Hanover Bank & Trust Company,* 34 N. Y. S. (2d) 166, the opinion in which appears in the appendix to our brief in support of the petition.

Respondents' emphasis placed upon the contention that petitioner here was the trustee of an express trust, holding legal title, is misplaced. While we contend (Brief in support of petition p. 19, footnote) that, in all substantial respects,

petitioner was no more a trustee than the fiduciaries involved in the Title Guarantee and Trust Company and New York Title & Mortgage Company cases, our chief contention on this question is that under the New York cases it makes no difference whether petitioner was technically a trustee or some other sort of fiduciary. The trustees of the debtor, respondents herein, themselves argued (R. 279), in a brief presented to the Circuit Court of Appeals in 1935:

> "The mortgages which are in the **physical possession* of the appellants as trustees constitute collateral *owned by the Debtor* subject to the lien of the indentures, and are held by the appellants *as security* for the payment of the bonds issued under the indentures. The instruments, labeled 'Trust Indentures,' *are in substance and effect merely mortgages or pledges of the Debtor's property. This is apparent from a mere casual inspection of the indentures.*"

The Circuit Court of Appeals accepted this view, and jurisdiction of the bankruptcy court in the 77B proceedings was predicated upon the Debtor's property rights as owner of the collateral. *In re Prudence-Bonds Corporation,* 77 F. (2d) 328, 330, cert. den. 296 U. S. 584. The only question before the New York Court of Appeals in *Pres., etc., of Manhattan Co.* v. *Prudence Co.,* 266 N. Y. 202, was whether an actionable event of default had occurred which authorized the indenture trustee to take over the servicing and management of the collateral. No question was raised or decided as to whether a trust existed and the court's expression on that subject was sheer dictum. The Circuit Court of Appeals indicated that such was the fact in *In re Prudence Bonds Corporation,* 79 F. (2d) 212, 217.

Respondents have argued that an injustice will be done unless they prevail on the merits. While this is not the place to discuss that contention, which has already been referred to in our brief in support of the petition (footnote p. 24),

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*All italics in quotations in this brief are supplied.

we wish to emphasize that if the decision of the Circuit Court of Appeals below stands, a New York corporate trustee will not only be liable in a class suit in the federal court to all current bondholders for a past breach of trust, but also, under the New York decisions relied on in our brief in support of the petition, will be liable to bondholders who held their bonds at the time of the breach of trust and who prosecute individual claims against the trustee in the New York state courts. See *Hansberry* v. *Lee,* 311 U. S. 32.

SECOND: The statute of limitations.

None of the New York decisions cited by respondents involve corporate trust indentures, except *Zebley* v. *Farmers Loan & Trust Company,* 139 N. Y. 461. That case, besides being earlier than the cases on which we rely, is not in point. It arose on demurrer to a complaint the principal allegations of which have been summarized above. The grounds of the demurrer were: (1) that the complaint did not state facts sufficient to constitute a cause of action; (2) that the court had no jurisdiction of the subject of the action; and (3) that there was a defect of parties (139 N. Y. p. 467). On the first ground defendant contended that the claim was a stale one which a court of equity will not entertain. The Court of Appeals (*id.* pp. 468-469) pointed out that, even where the complaint on its face discloses a cause of action barred by the statute of limitations, the question could not be raised by demurrer but must be raised by answer. The sentence relied upon by respondents (Brief, p. 29) was obviously dictum.

None of the cases cited by us in our point on the statute of limitations is referred to in the answering brief, except *Rhinelander* v. *Farmers Loan & Trust Company,* 172 N. Y. 519, and respondents' attempted distinction, whatever may be thought of its applicability to that case, cannot apply to those other cases (See Brief in support of Petition, pp. 27-30).

Respondents refer (Brief, p. 6) to certain injunction orders, upon which they argue (Footnote, p. 14) that petitioner, having secured injunctions against suits for accounting in the state courts, now says that the state court is the proper forum, but that the six-year statute of limitations "which petitioner says has been running meanwhile, will apply to any objections". This implication is not justified. The Special Master found (R. 464) that:

> "No order of this Court at any time enjoined any action by any holder of Prudence-Bonds, Twelfth Series, against Manufacturers Trust Company for damages sustained by said bondholder by reason of any alleged breach of trust referred to in the objections."

This finding was one of those to which objection was sustained in a blanket ruling by the District Court (R. 502). However, if the injunction orders should be construed to bar individual actions by bondholders for alleged breaches of trust by petitioner, the statute of limitations would of course be tolled during the period of such injunction. If, on the other hand, those injunctions should not be construed as barring such suits, access to the courts has at all times been available to the bondholders. Neither the Special Master, the District Court nor the Circuit Court of Appeals mentioned this contention of respondents in their opinions.

THIRD: Jurisdiction.

There is no new argument in respondents' treatment of the question of jurisdiction which merits reply. Respondents (Brief, p. 32) mistakenly suppose that our contention that any recovery from petitioner would not constitute property of the Debtor is based chiefly upon the fact that the Debtor "was a participant in the wrongful acts objected to". This subject is dealt with fully at page 32 of our brief in support of our petition.

The asserted "acquiescence" by petitioner in the jurisdiction of the bankruptcy court to pass upon the objections to its account is not only immaterial but was limited by the statement of petitioner's counsel at the hearing before the Special Master (R. 296):

> "MR. BARNETT: I admit they [the assignments of mortgages from Debtor to petitioner] were sufficient to pass a title which I call a record title, but under the law of pledges, that the title remains with the pledgor, and I say that rule is the basis of this Court's jurisdiction. If you hold that the title is not in the pledgor, then we have no right to be here anyhow."

In a footnote on page 9, and at page 31 of their brief, respondents refer to the fact that the record on appeal in the case of *Central Hanover Bank and Trust Company, et al.* v. *President, etc., of Manhattan Company, et al.,* 105 F. (2d) 130, while incorporated into the present record by reference (R. 203), has not been filed with this court on the present petition. We believe that, upon this petition for certiorari, the jurisdictional question sufficiently appears from the record in this proceeding and the opinion of the Circuit Court of Appeals at 105 F. (2d) 130, but, in case the court wishes to refer to the record on that former appeal, we are, with this reply brief, filing a copy of that record with the clerk.

Respectfully submitted,

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Dated: New York, May 21, 1942.